FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429
Division of Insurance

April 24, 2001

MEMORANDUM TO: Board of Directors

FROM: Arthur J. Murton, Director
Division of Insurance

SUBJECT: SAIF Assessment Rates for the Second Semiannual Assessment Period of 2001

Recommendation

The staff recommends that the Board maintain the existing Savings Association Insurance Fund (SAIF) assessment rate schedule of 0 to 27 basis points (bp) per year. This rate schedule complies with the statutory requirements for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the target Designated Reserve Ratio (DRR), currently 1.25 percent.

Summary

The Federal Deposit Insurance Act (FDI Act) governs the authority of the Board to set SAIF assessment rates and directs the Board to establish a risk-based assessment system for insured depository institutions and set assessments to the extent necessary to maintain the reserve ratio at 1.25 percent. The reserve ratio for the SAIF stood at 1.43 percent (unaudited) as of December 31, 2000. Staff projections indicate that the reserve ratio is likely to remain at or above 1.25 percent through the end of 2001, if insurance losses and deposit growth vary within their recent, moderate ranges. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the second semiannual period of 2001, and the staff consequently recommends no changes to the rate schedule.

Some institutions will pay premiums under the schedule even though the reserve ratio equals or exceeds the target DRR; however, the view of the staff is that the current schedule is consistent with the statutory requirement to establish a risk-based assessment system. Based upon year-end 2000 data and projected ranges for the relevant variables as of year-end 2001, this rate schedule would result in an average annual assessment rate of approximately 0.42 bp.

ANALYSIS

In setting assessment rates since capitalization of the SAIF, the Board has considered: (1) the balance between revenues and expenditures over time, (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.[1]

Long-Run Considerations

Based on a thorough review of FDIC experience and consideration of statutory changes designed to moderate future deposit insurance losses (e.g., prompt corrective action authority, national depositor preference and the least-cost resolution requirement), previous analysis conducted by FDIC concluded that an effective SAIF assessment rate of 4 to 5 bp annually would be appropriate to achieve long-run balance between SAIF revenues and expenses (where expenses include monies needed to prevent dilution due to deposit growth). Thus, upon capitalization in 1996, the "base" rate schedule for the SAIF was established at 4 to 31 bp annually. Given conditions of slow to moderate deposit growth and minimal insurance losses, which reduced the need for assessment revenue, the Board simultaneously shifted the effective

[1] The Board is required to review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the funds; e) the effect of assessments on the earnings and capital of fund members; and f) any other factors that the Board may deem appropriate. These factors directly affect the reserve ratio prospectively and thus are considered as elements of the requirement to set rates to maintain the reserve ratio at the target DRR.

annual rate schedule downward to 0 to 27 bp.[2] The Board did not alter the base rate schedule, which remains today at 4 to 31 bp. In recommending that the Board maintain the base schedule at 4 to 31 bp, the staff previously expressed the view that a rising SAIF reserve ratio was not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. Recent events demonstrate the volatility of the reserve ratio and further support this view.

Maintaining the Target DRR Over the Next Assessment Period

The SAIF reserve ratio stood at 1.43 percent as of December 31, 2000 (unaudited), the latest date for which complete data are available. In view of the current and projected levels of the SAIF reserve ratio, the current rate schedule appears to be consistent with the statutory requirement to maintain the target DRR of 1.25 percent.

The financial institutions industry could face increasing challenges over the coming months due to signs of slower economic growth, reduced corporate profits, and reduced consumer confidence. The significance of any financial problems that may develop at insured institutions is largely dependent on the duration and depth of the current economic slowdown. Concerns over slowing economic conditions are tempered by the overall strength of the industry, which by most measures is much stronger than it was going into the economic recession of 1990 to 1991.

With the slowing economy as a backdrop, the FDIC continues to monitor a number of areas that pose risks to SAIF-insured institutions. Among these concerns are the risk selection practices evident in a number of institutions over the past several years, which included a significant growth in higher-risk lending products such as subprime consumer loans and high

[2] The FDIC may alter the existing rate structure and may change the base SAIF rates (currently 4 to 31 bp) by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to

loan-to-value mortgages. The performance of these two relatively new loan types has not been tested through an economic downturn. Also noteworthy has been the growth in lending concentrations for a number of institutions in areas historically associated with higher loan loss rates including construction financing, commercial real estate lending, and commercial lending. In addition, the FDIC continues to monitor the growing reliance on non-deposit funding sources, which has contributed to an ongoing decline in net interest margins (NIMs) and in some cases an increasing sensitivity to rising interest rates. The recent decline in short-term interest rates prompted by easing Federal Reserve monetary policy could alleviate the pressure on NIMs for many institutions. However, a general decline in interest rates could also spur a significant growth in mortgage refinancing activity, which could lead to greater sensitivity to rising interest rates, especially for thrifts that generate a large volume of fixed rate loans for their own portfolios.

Taking appropriate steps to address these concerns continues to be a priority for the FDIC. The staff is addressing these risks through various means, including the enhancements to the risk-based premium system that became effective with the first semiannual assessment period of 2000. The enhancements are intended to provide a more flexible, forward-looking system that keeps pace with new and emerging risks. Call Report information is used to identify institutions with atypical risk characteristics among those in the best-rated premium category, and a review is conducted to determine whether there are unresolved concerns regarding risk management practices. Where such concerns are present, the institutions are given an opportunity to address the cited deficiencies with risk management practices before higher premiums are assessed.

During the last assessment cycle, the new Call Report screens flagged 31 SAIF-insured institutions, and one institution was notified that it would be a candidate for reclassification. In

---

increase or decrease the effective rate schedule up to a maximum of 5 bp, as deemed necessary to maintain the

the current cycle, the screens identified 29 SAIF-insured institutions for review, and the list of institutions was distributed to the other banking agencies in mid-April. After a review period that will end in May, the agencies will meet to decide on the candidates for notification.

Because the financial condition of the industry is strong, the current concerns regarding a rising level of risk exposure are not expected to generate a large increase in failures or SAIF losses over the near term. With regard to maintaining the target DRR through the next assessment cycle, the staff's judgment is that the current assessment rate schedule is appropriate. Following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio through December 31, 2001.

1. Fund Balance

The unaudited SAIF balance was $10.8 billion on December 31, 2000. For a given assessment rate schedule, changes in the balance over the short run are determined largely by changes in insurance losses and interest income, and unrealized gains and losses on available-for-sale (AFS) securities.

Insurance Losses. Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions that have already failed. Potential changes in contingent liabilities for the twelve months ending December 31, 2001, reflect the range of year-end 2000 estimates from the Financial Risk Committee (FRC) plus any adjustments for potential losses on failures that have occurred since December 31, 2000. The resulting range for changes in contingent liabilities is $50 million to $500 million.

Table 1 (next page) projects low and high estimates for the provision for losses based on the changes in contingent liabilities and an adjustment for the net recovery value of closed thrifts in receivership as of December 31, 2000.

---

target DRR.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
December 31, 2000 to December 31, 2001

	Low Loss Estimate	**High Loss Estimate**
Contingent Liability for Future Losses	$50 million	$500 million
Allowance for Losses: Closed Institutions (2)	$0	$0
Total Provision for Losses	$50 million	$500 million

Notes:

(1) Both projections reflect the information available as of March 31, 2001, regarding future economic conditions.

(2) Assumes a range of approximately –5 percent to +5 percent of the estimated net recovery value of thrift resolutions. As of December 31, 2000, the estimated net recovery value of thrift resolutions was $0.

Interest Income and Unrealized Gains and Losses on AFS Securities. The average SAIF investment portfolio for the twelve months ending December 31, 2001, is estimated to be approximately $10.8 billion. Based on the possibility of a shift in the level of interest rates of plus or minus 100 bp for new investments, interest income is projected to be between $651 million and $667 million for the twelve months ending December 31, 2001. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the change in market value of the securities dominates the effect of changes in interest income. Therefore, in Table 2, the higher interest rate scenario drives the low projected fund balance.

Table 2 on the next page summarizes the effects on the fund balance of the low and high estimates that define the ranges assumed for interest income, unrealized gains and losses on AFS securities, and insurance losses.

Table 2
Projected Fund Balance (1)
($ in millions)

	Low Projected Balance	High Projected Balance
Assessments (2)	35	35
Interest Income (3)	667	651
Total Revenue	702	686
Operating Expenses	120	120
Provision for Losses	500	50
Total Expenses & Losses	620	170
Net Income	82	516
Unrealized Gain (Loss) on AFS Securities (3)	(29)	147
Comprehensive Income (4)	53	663
Fund Balance (Unaudited) – 12/31/00	10,759	10,759
Projected Fund Balance – 12/31/01	10,812	11,422

Notes:

(1) Projected figures are for the twelve months from December 31, 2000, through December 31, 2001.

(2) Assumes that the current assessment rate schedule remains in effect through December 31, 2001.

(3) Portfolio yield is estimated to be between 6.06 percent (high projected balance) and 6.20 percent (low projected balance), reflecting a shift in the level of interest rates of + or – 100 bp from the level of interest rates as of the beginning of March 2001. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately $10.8 billion. Unrealized Gain (Loss) of AFS securities includes $57 million in gains for the year-to-date ending February 28, 2001.

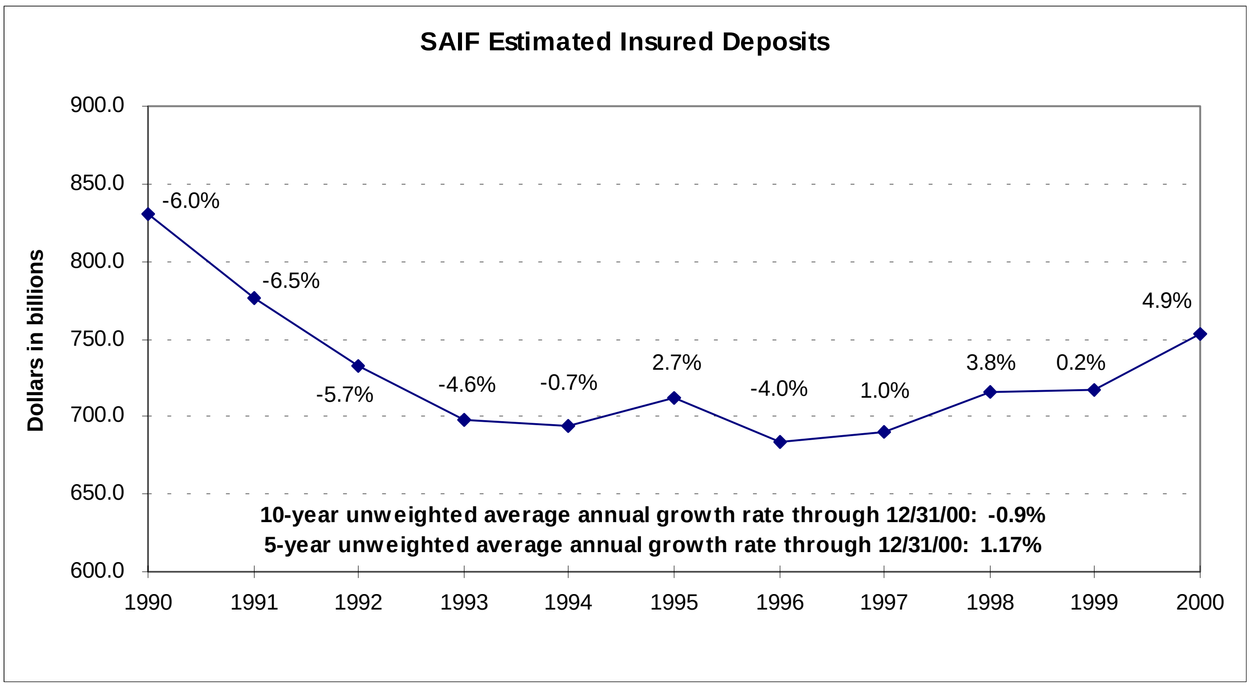
(4) Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rate. See note (3).

2. Insured Deposits

Although the total amount of SAIF-insured deposits has declined since the inception of the fund in 1989, insured-deposit growth in recent years has been mixed (see Figure 1, next page). Through 1993, insured deposits declined by an average annual rate of 5.7 percent. Since then, SAIF-insured deposits have fallen in some years and risen in others, although the changes from year to year have not been significant. SAIF-insured deposits increased by 4.9 percent in 2000, the highest since the inception of the fund.

The strong deposit growth in 2000 was most likely influenced by stock market volatility in combination with a favorable interest rate environment, which made CDs relatively more attractive to investors. Deposit growth was strong in the fourth quarter, but the Federal Reserve started lowering benchmark interest rates in the first quarter of 2001. Lower interest rates could make CDs and other interest-bearing deposit accounts less attractive this year, however, continued stock market volatility in the first quarter suggests that deposits may remain an attractive investment in the near term. In addition, potential reductions in federal debt levels could make short-term U.S. Treasury securities less prevalent, so that investors turn to alternatives such as insured deposits.

Figure 1



It takes about $5.5 billion in estimated insured deposit growth to create a 1 basis point change in the SAIF reserve ratio, all other things held constant. With the reserve ratio currently at 1.43 percent, it would take approximately $108 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else equal. $108 billion is about 14 percent of estimated insured deposits as of December 31, 2000. It is unlikely that deposit growth alone could drive the reserve ratio below 1.25 percent any time soon. Only if insurance losses rise significantly in combination with rapid deposit growth would the reserve ratio fall below its target in the near term.

According to information gathered by the FDIC, in addition to those investment firms with sweep programs in progress, there are other large brokerage/mutual fund companies with uninsured money market balances totaling in excess of $180 billion. These companies have not announced any plans to sweep these balances into insured accounts, but this cannot be ruled out. Virtually all of the largest banks in the system have an investment company affiliate. To date, no SAIF-insured institutions have experienced significant inflows of insured deposits due to the sweeps programs.

In the last recommendation to the Board regarding SAIF assessment rates, the staff suggested a range of insured deposit growth from 0 to +5 percent. In light of recent experience, the view of the staff is that at least some deposit growth should be expected and stronger deposit growth cannot be ruled out. Thus, the staff projects SAIF-insured deposit growth in the range of +1 percent to +5 percent between December 31, 2000 and December 31, 2001.

3. SAIF Reserve Ratio

Based on the projected SAIF balance and the projected growth of the insured-deposit base, the staff expects the SAIF reserve ratio to be within the range of 1.37 percent to 1.50 percent at December 31, 2001 (Table 3, next page). The low estimate, which produces a 6 bp decrease in the reserve ratio from December 31, 2000, reflects an assumed stronger increase in the insured deposit base (+5 percent) and a downward adjustment to the fund balance for unrealized losses on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by the FRC; the estimates are not intended to represent a “worst-case” scenario. The high estimate for the reserve ratio, which produces a 7 bp increase from the December 31, 2000 levels, reflects lower growth (+1 percent) in the SAIF-insured deposit base, stronger growth in the SAIF balance due to lower insurance losses, and an adjustment for unrealized gains on AFS securities.

Table 3
Projected SAIF Reserve Ratios ($ in millions)

	December 31, 2000	
Fund Balance (Unaudited)	$10,759	
Estimated Insured Deposits	$752,756	
SAIF Ratio	1.43%	
	Low Estimate (1) **December 31, 2001**	**High Estimate** (2) **December 31, 2001**
Projected Fund Balance	$10,812	$11,422
Estimated Insured Deposits	$790,393	$760,284
Estimated SAIF Ratio	1.37%	1.50%

Notes:

(1) The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.20 percent, unrealized losses on AFS securities-see Note 3 in Table 2), a higher provision for losses ($500 million) and a higher insured deposit growth rate (+5 percent).

(2) The high estimate refers to the scenario of lower interest rates (portfolio yield: 6.06 percent, unrealized gains on AFS securities-see Note 3, Table 2), a lower provision for losses ($50 million) and a lower insured deposit growth rate (+1 percent).

The staff expects that the actual reserve ratio at year-end 2001 will exceed 1.25 percent. Even if the low estimate were to be realized, the current rate schedule will be sufficient to maintain the DRR through year-end 2001.[3] It should be noted also that the SAIF could withstand approximately $930 million more in losses than the pessimistic scenario without falling below the DRR as of December 31, 2001.

Risk-based assessment system. The staff recommends retaining the current spread of 27 bp between the highest- and lowest-rated institutions as well as the rate spread between adjacent cells in the assessment rate matrix (see Table 4). The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of

[3] Note: In contrast to refund provisions for BIF members, refunds for SAIF members generally are not permitted.

risk-based assessments. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. The estimated annual revenue from the existing rate schedule is $35 million, up from $22 million in the previous period. The staff has considered the impact on earnings and capital of the current rate schedule and found no unwarranted adverse effects.

Table 4
Proposed Assessment Rate Schedule
Second Semiannual Assessment Period of 2001
SAIF-Insured Institutions

Capital Group	A	B	C
1. Well	0 bp	3 bp	17 bp
2. Adequate	3 bp	10 bp	24 bp
3. Under	10 bp	24 bp	27 bp

The Assessment Base Distribution and Matrix Migration

Table 5 summarizes the distribution of institutions across the assessment matrix.

Table 5
SAIF Assessment Base Distribution (1)
Deposits as of December 31, 2000
Supervisory Subgroup and Capital Groups in Effect January 1, 2001

Capital Group		A		B		C	
1. Well	Number	1,184	88.8%	102	7.7%	15	1.1%
	Base ($billion)	777.2	94.5%	26.9	3.3%	7.3	0.9%
2. Adequate	Number	15	1.1%	10	0.8%	4	0.3%
	Base ($billion)	4.5	0.5%	2.3	0.3%	4.0	0.5%
3. Under	Number	1	0.1%	0	0.0%	2	0.2%
	Base ($billion)	0	0.0%	0	0.0%	0.3	0.0%

Estimated annual assessment revenue	$35 million
Assessment Base	$ 822.6 billion
Average annual assessment rate (bp)	0.42 basis points

Notes:

(1) "Number" reflects the number of SAIF members (excludes BIF Oakars). "Base" reflects all SAIF-assessable deposits.

With 97.6 percent of institutions and 98.3 percent of the assessment base in the three lowest assessment risk classifications of “1A,” “1B,” and “2A,” the current distribution in the rate matrix reflects little fundamental difference from the previous period when the percentages were 98.1 percent and 98.9 percent, respectively. The slightly lower number of institutions in these three categories (down 41) reflects continuation of industry consolidation trends, as the overall total declined by 35 institutions. There are 32 institutions outside of the “1A,” “1B,” and “2A” classifications, up from 26 in the previous period.

Only 149 institutions are currently classified outside of the lowest assessment risk classification compared to 136 from the previous period. Of the 136 institutions that were previously classified outside of the "1A" assessment risk classification, 19 institutions migrated into the "1A" risk classification in the current distribution (Table 6). Of the 1,232 institutions that were classified "1A" as of the previous assessment period, 37 institutions migrated out of the "1A" risk classification. Overall, the supervisory subgroup assignment was upgraded since the previous period for 13 institutions with an assessment base of $3.7 billion and was downgraded for 40 institutions with an assessment base of $16.5 billion.

Table 6

SAIF Migration To and From Assessment Risk Classification "1A" (1)

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	7	1.8
Due to supervisory subgroup reclassification only	12	3.4
Due to both	0	0
Total	19	5.2
Institutions leaving "1A"	**Number**	**Base ($billion)**
Due to capital group reclassification only	5	0.7
Due to supervisory subgroup reclassification only	31	14.2
Due to both	1	0.1
Total	37	15.0

Notes:

(1) Reflects SAIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2000 to the first semiannual assessment period of 2001. The numbers only include institutions that were rated in both periods.

Other Issues

FICO Assessment. The Funds Act separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the SAIF rate schedule. The Funds Act also required that, as of January 1, 2000, all BIF- and SAIF-insured institutions would pay the same rates on their assessable deposits. The FICO rate on SAIF-assessable deposits for the second semiannual period of 2001 (subject to quarterly adjustment) will be determined using March 31, 2001, Call Report and Thrift Financial Report data in June 2001.

Staff Contacts

Karen A. Denu, Chief, Assessments Evaluation Section, Division of Insurance (202) 898-3810, or Claude Rollin, Senior Counsel, Legal Division (202) 898-8741. For FICO assessment information, please contact Richard Jones, Chief, Assessments Implementation Section, Division of Insurance, at (202) 898-6592.